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COMPETITION BUREAU RELEASES BANK MERGER GUIDELINES

The Competition Bureau today released its final Merger Enforcement Guidelines as Applied to a Bank Merger (Bank Merger Enforcement Guidelines) following an extensive public consultation.

The Bureau's consultation process on how best to apply the Merger Enforcement Guidelines to Schedule I banks was launched in November 1997 at the time of its submission to the Task Force on the Future of the Canadian Financial Services Sector. In addition to soliciting written commentary, the Bureau has met with a wide range of stakeholders, including consumer, labour and small business organizations, the legal community, academics, banks, trust companies, credit unions, insurers and interested individuals.

The approach outlined in the Bank Merger Enforcement Guidelines is applied to what banks do rather than what they are. As a result, it is not a tool solely applicable to banks, but it may also be used to analyse other mergers in the financial services sector. Indeed, the activities of other financial and non-financial institutions are important considerations in determining whether any single merger among Schedule I banks is likely to contravene the *Competition Act* (*Act*).

The main objective of the merger review process is to maintain and promote competition within the Canadian economy in order to provide consumers with a wide variety of high quality products that are competitively priced. More specifically, the *Act* provides that the Competition Tribunal may order remedies when a merger prevents or lessens, or is likely to prevent or lessen competition substantially. An efficiency exception to otherwise anti-competitive mergers is provided, however, when there are sufficient cost savings to outweigh the competitive harm likely to arise as a result of the merger and these savings would not be realized without the merger. In such circumstances, the Competition Tribunal shall not make an order against the merger.

Specific Issues for Consultation

For clarification, the Bureau did not propose consultations on the fundamental conceptual framework underpinning the Merger Enforcement Guidelines. Rather, it sought comments on how best to apply the established analytical framework found in the Merger Enforcement Guidelines to the banking sector as a whole, while taking into account the unique characteristics of banking and its role in the Canadian economy. While the Bureau appreciated receiving views on all aspects of the proposed approach, it was particularly interested in comments on the following nine questions:

1. When dealing with a proposed merger within the banking sector, should the Bureau assess the transaction:

- i) strictly on its own merits;
- ii) taking into account any other merger transactions which are likely to occur; or
- iii) in relation to the probable evolution of the sector as a whole.

How should this analysis proceed?





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2. The Bureau proposes that it apply the existing 35% and 65%/10% market share/concentration thresholds when assessing the competitive effects of a bank merger.¹ These thresholds are only rules of thumb to determine whether further analysis is warranted, and do not in any way indicate that a transaction will be challenged. Are there factors specific to the banking sector to suggest that these thresholds should be adjusted?
3. Many banking markets are characterized by the continual introduction of innovative products and distribution channels, as well as changes in regulations. Are the principles for assessing the future competitive significance of such developments stated in the Draft Bank Merger Enforcement Guidelines appropriate?
4. In order to assess the effects of a merger on competition, the Bureau calculates the shares of market participants. Market shares can be calculated either on the basis of output, or on the basis of capacity to supply the relevant product. For which banking products is it most appropriate to calculate shares on the basis of capacity?
5. The Bureau has proposed calculating market shares and concentration levels in a set of pre-defined product offerings and geographic areas as an initial screening test, to permit quick identification of the markets which are likely to give rise to competition concerns. What factors should be considered to further refine the analysis to reflect consumer purchasing patterns for retail banking?
6. Competition in a market can be lessened substantially as a result of a merger when it provides the incentive and ability for firms to exercise market power either unilaterally or interdependently. The factors that influence this incentive and ability are discussed in the Draft Bank Merger Enforcement Guidelines. How significant are each of the factors in the case of a bank merger and are there others to be included?
7. Are the general approaches to dealing with supply substitution and barriers to entry for merger review appropriate for a bank merger?
8. In addition to the regulatory barriers facing foreign banks, the Bureau will also be assessing the economic incentives of foreign banks to enter Canadian banking should any of the current regulatory restrictions for foreign branch retail banking be removed by the Government. If some of these restrictions were removed would foreign banks likely enter Canadian banking, or are there non-regulatory factors that reduce this incentive?

¹ Generally, mergers will not be challenged on the basis of concerns relating to the unilateral exercise of market power where the post-merger market share of the merging parties would be less than 35 per cent, and mergers will not be further reviewed on the basis of concerns relating to the interdependent exercise of market power where the share of the market accounted for by the largest four firms in the market post-merger would be less than 65 per cent and the merging parties would hold less than 10 per cent of the market.

9. The Bureau has proposed that it continue to apply a total welfare standard when assessing the efficiency exception for a bank merger. Under this approach, cost savings do not have to be passed through to consumers in order to be included in the analysis. Are there factors specific to bank mergers that would suggest an alternative welfare standard should be adopted?

Results of Consultations

The Bureau is pleased to report that there is widespread agreement that the general principles articulated in the Merger Enforcement Guidelines can be applied to financial institutions, with some modest refinements. The following key issues have been raised by commentators:

1. When dealing with a proposed transaction when there are multiple mergers before the Bureau, as exists now, the vast majority of commentators stated that these must be examined simultaneously. At the same time, the Bureau should not unnecessarily delay the review of any single transaction. Finally, as previously announced, it would be imprudent to determine the competitive implications of these proposed mergers prior to release of the recommendations of the Task Force on the Future of the Canadian Financial Services Sector.
2. No commentator argued for different market share and concentration thresholds to be applied to bank mergers, from those currently found in the Merger Enforcement Guidelines. Nonetheless, when applying these thresholds, care must be taken to include all closely substitutable products for consumers. These may be offered by banks, other financial institutions, non-financial institutions and foreign-based companies. A number of commentators noted that this would mean gathering comparable data to that found in the Canadian Bankers² for those participants in Canadian financial services who are not members of the CBA.
3. Many commentators noted the importance of innovation and electronic banking. Electronically delivery of banking products and services may reduce the importance for customers of being in close proximity to a bank branch, and as a result, may expand relevant geographic markets for banking products and services. In addition, delivering products and services electronically is less expensive than through personal contact at a branch, and hence may reduce the costs of entry for foreign and domestic financial institutions. However, there were differing views expressed about how close a substitute electronically delivered banking products actually are for personal contact through a branch. Electronic banking is a relatively recent phenomenon and questions arise as to the extent to which it will be embraced by retail customers and small businesses. In addition, there may be certain banking products or services which are not conducive to electronic delivery or certain segments of the population to whom electronic

² Among the Bank of Canada, OSFI and the Canadian Bankers' Association (CBA), the CBA has the most comprehensive, readily available database on bank branch level activity. The data consists of branch level sales information on a number of product offerings for many of the CBA members and non-members (including the four merging parties) based on the first three digits in the postal code of each represented branch (referred to as FSAs or forward sorting areas).

banking is not an acceptable substitute to branch banking. In sum, while there was agreement that the Bureau should pay close attention to electronic distribution channels, there was no consensus on their current or future competitive significance.

4. Generally, commentators noted that capacity is probably a better measure of competitors' likely supply response to a hypothetical price increase by the parties post-merger, but that it is an extremely difficult construct to create. As a result, most commentators agreed that for practical purposes output is an acceptable alternative to use when measuring market shares and industry concentration in banking.

5. On pre-defined geographic markets there was criticism of use of commuting data for determining geographic market boundaries. Reference was made to the data held by the CBA as a preferable database to that of Statistics Canada, since this is based on the first three digits in the postal codes of branches (known as forward sorting areas). In addition, there was not much acceptance for defining product markets on the basis of pre-defined "clusters".³

6. On the question of likelihood of coordinated effects, there were differing opinions expressed on whether this was already an occurrence in banking and how likely it might be post-merger. However, there were no objections expressed in terms of the relevant factors to be examined to assess the likelihood of coordinated effects post-merger in banking.

7. Commentators agreed that the general approaches to supply substitution and barriers to entry found in the Merger Enforcement Guidelines are appropriate for banking.

8. On the question of foreign competition, the criteria found in the Draft Bank Merger Guidelines were found to be sound. In addition, several submissions described the hurdles which a foreign financial institution must overcome before being able to offer service in Canada.

9. On the question of whether any cost savings resulting from the mergers of banks should be required to be passed through to consumers, the Bureau received conflicting advice. The standard which the Bureau currently follows is no different from the traditional benefit-cost analysis applied to other public policies. Some commentators do not believe the existing standard needs to be changed and others have argued for ensuring that consumers must benefit from any expected efficiencies. It should be noted that in suggesting an alternative, more customer-oriented approach, some commentators felt that this should apply to all mergers and not just those involving banks. The Bureau did not receive concrete suggestions about how the

³ This approach is used by the U.S. Federal Reserve Board in their examinations of banking mergers. Product markets are pre-defined into certain clusters, such as "commercial banking" with total deposits used as a proxy for the ability of commercial banks to provide this cluster to businesses and households. By rejecting the notion that each product or service line may constitute a relevant market, the cluster approach reduces the number of competitors considered to those who currently or potentially offer deposit services.

Competition Tribunal might ensure that cost savings achieved by merging parties would be subsequently passed through to customers.

Finally, in addition to the views expressed above, the consultations also raised questions about the procedural interaction between the Director under the *Competition Act* and the Minister of Finance under the *Bank Act*.

Revisions to the Draft Bank Merger Enforcement Guidelines

As a result of the broad consensus, the Final Merger Enforcement Guidelines as Applied to a Bank Merger do not differ greatly from the Draft Guidelines issued in November. In its assessment of bank mergers, the Bureau will continue to use:

- i) the existing 35% and 65%/10% market share and industry concentration thresholds;
- ii) the outlined principles for assessing the future competitive significance of developments in electronic delivery of banking products and services;
- ii) the described factors used to assess firms' incentives and abilities to exercise market power either unilaterally or interdependently;
- iv) the current approach for dealing with supply substitution and barriers to entry;
- v) the stated analytical framework for determining the economic incentives of foreign financial institutions compete in Canada should certain regulatory barriers be removed by the Government; and,
- ii) the total welfare approach to efficiencies analysis as the Bureau is not convinced that the nature of potential cost savings and the possible anti-competitive effects stemming from bank mergers are sufficiently distinct from mergers in other sectors of the economy to adopt a different standard.

Changes have been made in the following three areas: (a) dealing with any single transaction when there are multiple mergers; (b) calculation of market shares; and, (c) use of a screening test. In addition, (d) an annex setting out the procedural interaction between the Director under the *Competition Act* and the Minister of Finance under the *Bank Act* has been appended.

(a) Dealing with Multiple Mergers

The Bureau agrees that multiple mergers should be dealt with concurrently. The Bureau has already initiated investigations into the two proposed transactions between the Royal Bank of Canada and the Bank of Montreal, and between Canadian Imperial Bank of Commerce and Toronto Dominion Bank. In addition, the Bureau is of the view that it will be able to arrive at decisions on these two mergers in a timely manner following release of the recommendations of the Task Force on the Future of the Canadian Financial Services Sector.

(b) Calculation of Market Shares

The market shares of existing market participants can generally be measured in terms of dollar sales, unit sales or production capacity. In cases where products are undifferentiated and firms have excess capacity, capacity is normally a better reflection of a firm's relative market position and competitive influence than output. However, in the case of bank mergers, it is inherently difficult to quantify capacity. Since data on sales of banking products is more readily available than capacity data, the shares of market participants will be calculated on the basis of actual sales volumes. Information that suggests that this does not accurately reflect a particular firm's competitive significance in the market will be taken into account in the assessment of the potential anti-competitive effects of the merger.

(c) Initial Screening Test

In order to expedite its review process, particularly if local geographic markets are found to be important, the Bureau proposed using an initial screening test to quickly eliminate from further review the products and geographic areas which are not likely to give rise to competition concerns. This allows the Bureau to concentrate its review on the areas where a more thorough competitive analysis is required. Given the consensus that the 35% and 65%/10% market share and industry concentration thresholds are appropriate for banking mergers, the Bureau will use these in this initial screening test. However, concerns were expressed over the appropriate data set upon which this screening test would be applied. It has been recommended, and the Bureau has adopted, use of a database held by the CBA. The data consists of branch level sales information on a number of product offerings for many of the CBA members and non-members (including the four merging parties) based on the first three digits in the postal code of each represented branch (referred to as forward sorting areas). While not inclusive of all financial activity in the country, the CBA dataset is the best available either through the private or public sectors, and it does cover all of the branches of the four banks currently proposing mergers. The Bureau intends to augment the dataset with additional information from other sources, including the parties directly and their existing and potential competitors.

(d) Procedural Interactions

In order to address numerous questions voiced during the consultations concerning the procedural interaction between the Director under the *Competition Act* and the Minister of Finance under the *Bank Act* Annex I has been added. The Bureau will follow its practice of gathering information about the proposed bank mergers and in analysing their competitive effects, pursuant to the approach documented in the Bank Merger Enforcement Guidelines. As is customary, the Bureau will identify to the merging parties on an ongoing basis any likely competition concerns that may arise. Upon concluding his analysis, the Director will advise the parties and the Minister of Finance, in recognition of the latter's authority, about the likely competitive effects of the proposed transactions. Should a merger be found to likely substantially lessen or prevent

competition, the Director will set out in general terms the sorts of measures that have historically been applied to deal with anti-competitive mergers.

After hearing from the Bureau and upon taking into account any public interest concerns expressed by the Minister of Finance, the parties to a merger would then be in a position to determine if it is appropriate to explore potential remedies with the Bureau in relation to any of the competitive issues raised by the Director. In the event that the parties subsequently succeed in suggesting competitive remedies acceptable to the Director such remedies may, if appropriate, still require the approval of the Competition Tribunal. Finally, the resulting merger still needs to be approved by the Minister of Finance pursuant to the *Bank Act*.